Economic Outlook

Irving Trust

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Now that the slowdown in the economy has materialized, what comes next? Observers of the economy are focusing primarily upon three possibilities:

1. Recent signs of weakness are portents of an imminent recession.

2. Recent data are distorted by strikes and other temporary factors. The economy will bounce back quickly, forcing the Federal Reserve to push up interest rates and flirt with recession later in 1985.

3. The slowdown will continue into early 1985 but will be temporary; the economy will grow without interruption throughout the year.

Our assessment is that the third possibility--a soft landing--is decidedly the most likely. The slowing in the economy has a fundamental basis and is not merely a reflection of transient aberrations. At the same time, the situation is not likely to deteriorate into a full-fledged recession within the next 15 months.

Signs of the slowdown have become numerous. Industrial production fell 0.6% in September from the August level, which was itself only a shade above the July level. Moreover, September's decline was not simply a reflection of the auto strike since materials production also fell. In addition, the gains in payroll employment have been diminishing for the past three months, while manufacturers' new orders in August showed virtually no growth from the first quarter's average. Although the index of leading economic indicators rose 0.5% in August, the index was still 2.4% below the peak in May and just about even with the January figure. In the past, such protracted weakness in this indicator would usually --but not always--be followed by a recession.

The slowdown partly reflects a mini-inventory cycle in progress. The origin of the problem occurred early this year, when retailers experienced substantial sales gains. For example, department stores' sales in February were 14.6% higher than the level a year earlier. Retailers built up inventories aggressively during the spring following this favorable sales performance, but their euphoria was ill-timed, as sales faltered during July and August. By August, the year-over-year sales gain at department stores was only 9.2%, while inventories had increased 19.7% during the same period. September showed considerable improvement in sales, however, as both department stores' sales and all nonauto retail sales rose by a healthy 1.7% on a month-to-month basis. Consumers may have taken a siesta during the summer, but there is scant evidence that they have gone into hibernation.

As retailers cut back on orders to their vendors, manufacturers' new orders turned sluggish, and production had to be curtailed as their own inventory/sales ratios increased. The cycle will take several more months to correct itself. In the meantime, the Fed has allowed rates to fall in response to the sluggish economic performance and the weakness in M1. Had the Fed pushed up rates relentlessly, the risk of an imminent recession would be considerable. Since the opposite is the case, however, it appears that announcements about the demise of the economic recovery are premature.

Bernard Schoenfeld

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Economic Forecast

Percent Changes at Annual Rates

	Actual							Forecast	Actual	Forecast	
	1984				1985				1982-	1983-	1984-
	I	II	III	IV	I	II	III	IV	1983	1984	1985
Gross National Product	14.9	10.7	6.5	7.8	7.1	8.7	9.7	8.4	7.7	11.0	8.1
Real GNP	10.1	7.1	3.4	3.7	2.5	4.1	4.3	2.6	3.7	7.0	3.6
GNP Price Deflator	4.4	3.3	3.0	4.0	4.5	4.4	5.1	5.6	3.8	3.7	4.3

	Actual	Forecast	Actual	Forecast	
	1984: II	1984:III	1982-1983	1983-1984	1984-1985
Consumer Spending	10.2%	5.3%	8.6%	8.8%	7.7%
Durable Goods	13.2	3.7	14.2	15.0	8.1
Nondurable Goods	8.3	1.2	5.8	7.2	6.4
Services	10.8	9.0	9.4	8.4	8.6
Business Capital Spending	24.0	22.2	0.9	21.9	17.2
Structures	23.8	24.0	-8.7	18.5	16.6
Equipment	23.7	21.2	7.6	23.9	17.5
Residential Investment	12.2	-2.0	44.6	15.9	-1.9
			1983	1984	1985
Change in Inventories	$50.6b.	$53.0b.	$-13.5b.	$55.9b.	$39.3b.
Net Exports of Goods and Services	$-58.7b.	$-74.0b.	$-8.3b.	$-63.6b.	$-73.3b.
			1982-1983	1983-1984	1984-1985
Government Purchases	24.3%	11.1%	5.4%	9.0%	9.4%
Federal	50.5	13.0	4.2	9.7	13.6
Defense	14.6	13.3	11.7	11.8	13.0
Other	278.5	12.0	-12.7	3.5	15.5
State & Local	10.1	9.8	6.2	8.6	6.6
Corporate Profits Before Tax	24.1*	8.2*	22.8	21.6	8.9
Corporate Profits After Tax	21.7*	5.3*	21.6	18.8	8.6
Plant and Equipment Expenditures	13.7	20.0	-4.8	15.3	14.2
Real Final Sales#	10.3	2.5	3.2	5.2	4.1
Real Disposable Personal Income	6.3	4.2	3.5	6.8	3.9

Economic Indicators	Recent Data			Actual	Forecast	
	July	Aug.	Sept.	1982-1983	1983-1984	1984-1985
Consumer Price Index**	3.6%	6.0%	n.a.	3.8%	4.6%	5.0%
Producer Price Index for Finished Goods**	3.6	-1.2	-2.4	0.6	2.5	5.0
Industrial Production	10.9	1.4	-7.2	6.5	11.4	5.6
Retail Sales##	-1.7	-0.6	1.6	9.3	10.2	7.8
				1983	1984	1985
Auto Sales (millions of units, a.r.)	10.6	10.0	10.3	9.2	10.7	10.7
Housing Starts (millions of units, a.r.)	1.75	1.54	1.68	1.70	1.79	1.66
Unemployment Rate	7.5	7.5	7.4	9.6	7.5	6.8
Merchandise Trade Deficit (a.r.)	$168.7b.	$118.3b.	n.a.	$69.4b.	$129.5b.	$139.0b.

Unless noted otherwise, all data are period-to-period percent changes at annual rates, derived from seasonally adjusted data.

#GNP less change in inventories, both in real terms.
##Monthly percent changes are not annualized.
*Year-over-year percent changes.
**Annual percent changes are December to December (not seasonally adjusted).

$b. = billions a.r. = annual rate F = Forecast

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